M.A. & B.A., ECONOMICS

INTERNATIONAL ECONOMICS

EFFECTS OF TARIFF ON TERMS OF TRADE

E-Content in PPT format prepared by

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The various countries of the world have imposed tariffs (i.e., import duties) to protect their domestic industries. It has been said in favour of tariffs that through them a country can provide not only protection to its industries but under appropriate circumstances it can also improve its terms of trade, that is, tariffs under favourable circumstances enable a country to get its imports cheaper.

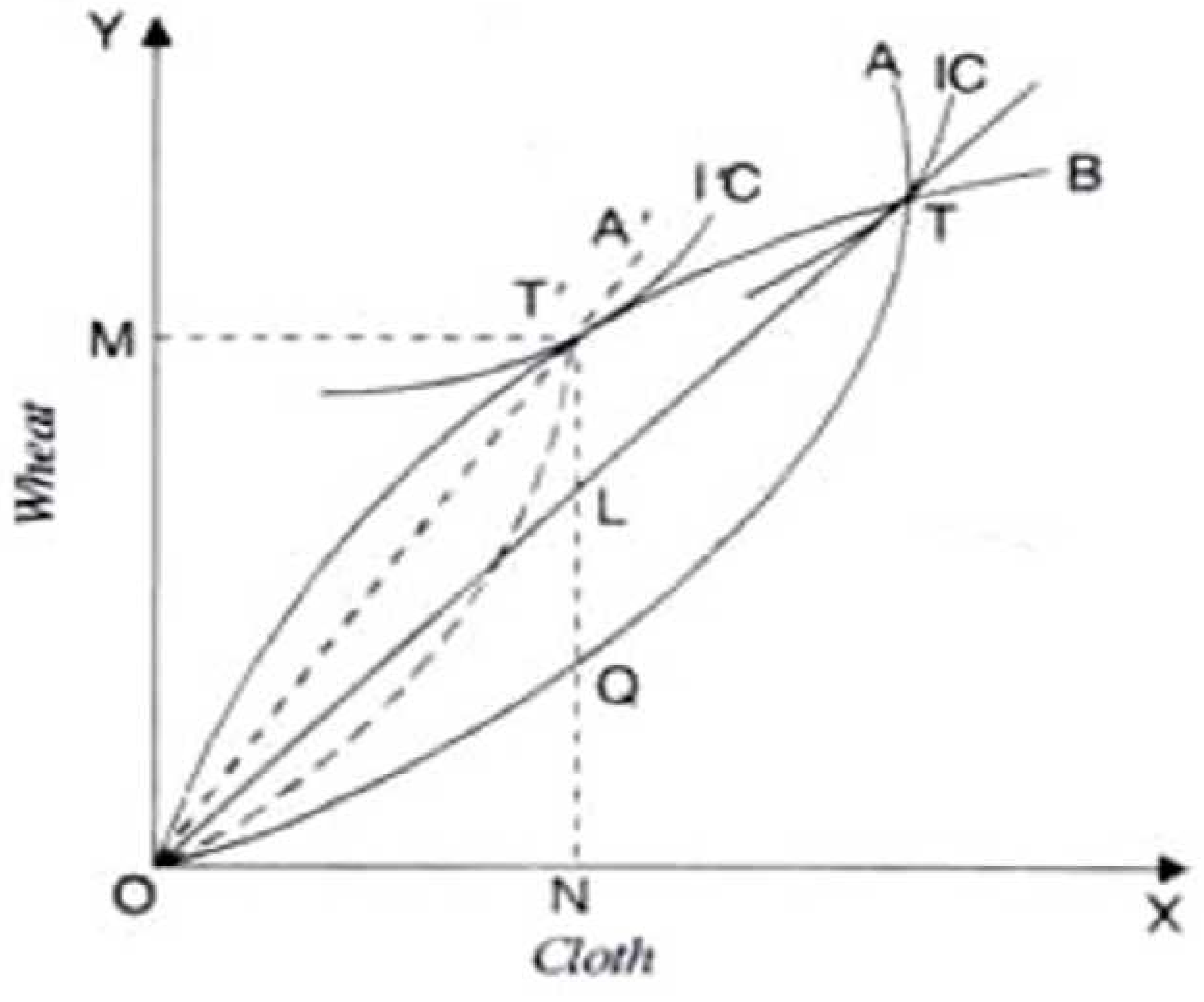
These favourable circumstances are:

- The demand for the exports of the tariff-imposing countries is both large and inelastic
- The demand for the imports by the country is quite elastic.

Under these circumstances, as a result of the imposition of tariff by that country, the imports of the country will decline since the price of the imported commodity will rise. But this is not the end of the story.

- The decline in imports of the tariff-imposing country would reduce the export earnings of its trading partner as it will lead to the decrease in demand for it exported commodity. The decrease in demand for the exported commodity in the trading partner would result in lowering its domestic price.
- As a result of the fall in the domestic price of the exported commodity and in order to maintain its export earnings the exporting country is likely to reduce the price of its exports. This means that the tariff- imposing country would now be able to get its imports at a relatively lower price than before.
- Given the demand and price of its exports, the fall in its prices of imports of the tariff imposing country would imply the improvement in its terms of trade. It is worth mentioning that the improvement in the terms of trade through tariff depends upon the changes in price and resultant changes in quantity demanded of imports and exports of the trading countries which in turn depend upon the elasticity’s of their reciprocal demand.

FIG 1: EFFECTS OF TARIFF ON TERMS OF TRADE



- The effect of tariff on the terms of trade can be explained through the geometrical device of offer curves. In Fig 1 the offer curves OA and OB respectively of the two countries A and B are shown. These offer curves intersect at T implying thereby that terms of trade equal to the slope of OT are determined between them.
- Now, suppose that country A imposes import duty on wheat from country B. As a result of this imposition of tariff, the offer curve of country A will shift to a new position OA '(dotted). This implies, for instance, that, before tariff, country was prepared to offer ON of cloth for NQ of wheat, but after imposition of tariff it requires NT' of wheat for ON of cloth and collects QT ' as import duty.

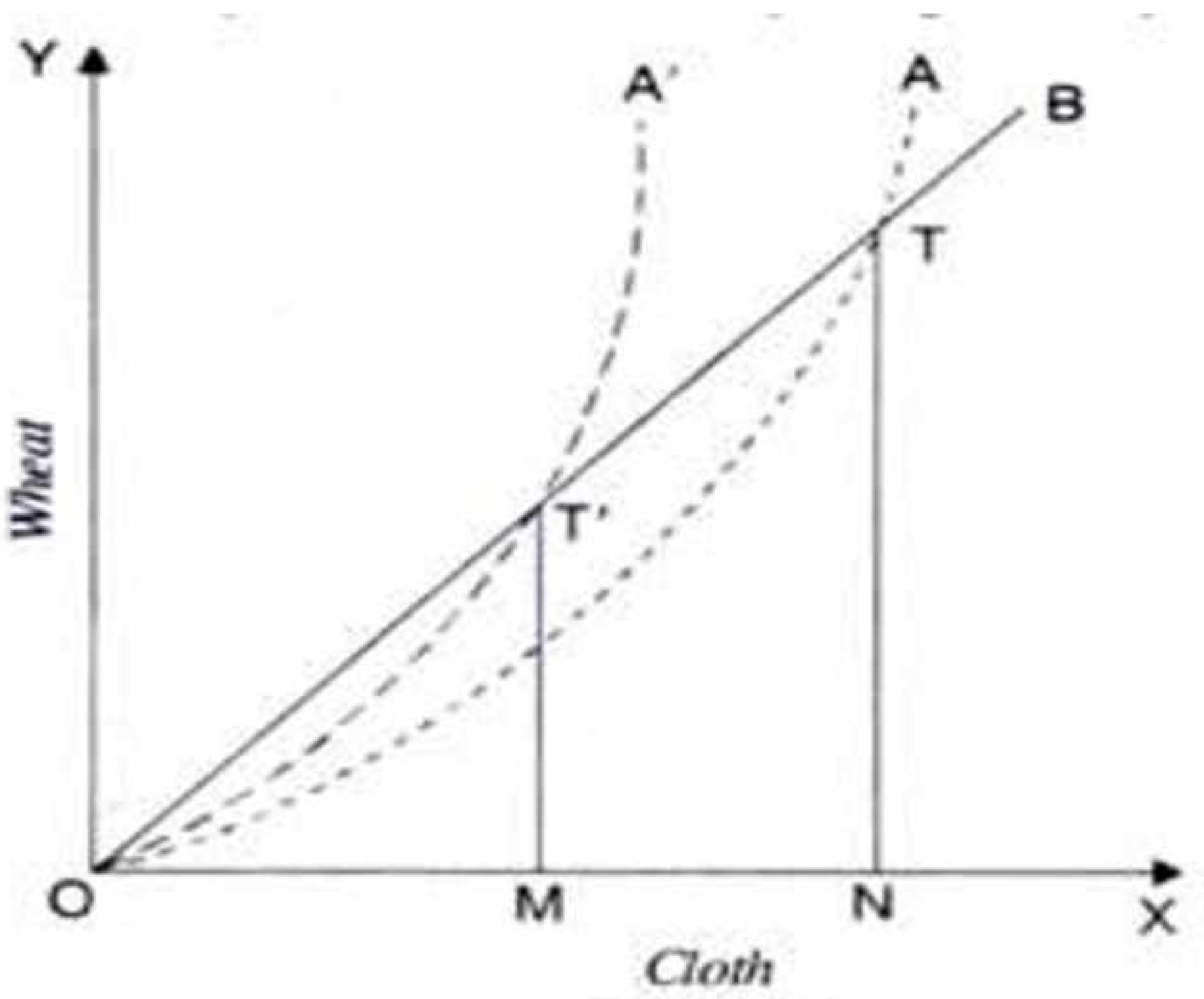
- It will be noticed from Fig 1 that the new offer curve OA '(dotted) of country A intersects the offer curve OB of country B at point T and thereby the terms of trade changes from OT to OT'. Note that the slope of the terms of trade line OT' is greater than that of OT'.
- Thus, terms of trade for country A have improved consequent upon the imposition of tariff by country A. For instance, whereas according to terms of trade line OT country A was exchanging ON of cloth for N L imports of wheat, it is now exchanging ON of cloth for NT' of wheat.

The following things are worth nothing about the impact of tariffs on terms of trade:

1. The gain in terms of trade from imposing a tariff depends on the elasticity of the offer curve of the opposite trading country. If the offer curve of the opposite trading country is perfectly elastic, that is, when it has constant costs so that offer curve is the straight line OB from the origin with slope equal to that of OT as shown in Fig 6, the imposition of tariff would reduce the volume of trade between them, the terms of trade remaining the same.

For example, if in the situation depicted in Fig 6 country A imposes a tariff on imports of a wheat from the country B and as a result the offer curve of A shifts upward to the new position OA’ (dotted), the terms of trade remain constant as measured by the slope of the terms of trade line OT. It will be seen from Fig 6 that in this case only volume of trade has declined from ON to OM

FIG 6



2.The gain in terms of trade from imposing a tariff will finally accrue to a country only in the absence of retaliation from the trading country B. But when one country can play a game to improve its position, the other can retaliate and play the same game. That is, on country A imposing a tariff on its imports from country B in a bid to improve its terms of trade, the latter can also impose a tariff on the imports from the former and thereby cancels out the original gain by country A. Such competition in imposing tariffs on each other's product would greatly reduce the volume of trade and leave the terms of trade between them unchanged.

As a result of the reduction in volume of trade, both countries would suffer a loss. "The imposi- tionof tariffs to improve the terms of trade, followed by retaliation, ensures that both countries lose. The reciprocal removal of tariffs, on the other hand, will enable both countries to gain. That is why different countries enter into bilateral agreements to reduce tariffs on each other's products." Fur- ther,there is now World Trade Organisation (WTO) which requires the member countries to reduce tariffs so that the volume of international trade expands.

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